THE FEDERAL RESERVE SYSTEM AND INFLATION

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THE question of inflation and its relationship to the Federal Reserve system and the banking policy of that system has now attained the proportions of an issue, and effort is being made in various quarters to locate what is called the responsibility for it. I wish at the outset to say that it does not seem to me that the history of the present inflation is of very large interest except for the purpose of indicating where errors in banking and public finance have been made, in order that we may correct them in the future. There was during the war only a minimum of effort to discuss the subject of inflation from the banking standpoint, and neither our economists nor our public men offered substantial leadership on the issue, so far as has come to my attention. Notwithstanding that the bankers of the country, as well as the economists, were from time to time freely consulted with reference to the whole subject, they practically declined to consider the problem in its bearings on credit and prices. It would have been disastrous to make problems of war finance a partisan issue during the continuance of hostilities, but there was nothing to prevent the non-partisan discussion of it from a scientific financial standpoint. As I have said, little or no such discussion occurred, and the responsibility for what has happened in connection with inflation is thus a general national responsibility.

Neither does it seem to me appropriate to discuss the subject of inflation as a peculiar product of the Federal Reserve system. Inflation has occurred from one cause or another in every country of the world, and prices have advanced more in many of them than they have in the United States. Most of the banking systems of the world are in a less solvent and liquid condition than is that of the United States. The United States has technically maintained gold payments, an achievement which was not possible during the Civil War. Federal

Reserve banks acted as the fiscal agents of the Government of the United States and any other system of banks or national bank depositaries, or a central bank, had one existed, would have done the same, as in duty bound to do.

What I have to say relates to the present problem of inflation and its relationship to the Federal Reserve system. The issue is partly one of financial policy. It is also a problem of political morality. Inflation has occurred in this country, as it has everywhere else, and the question now is how to get rid of it, or indeed whether we wish to get rid of it at all, for already there are two schools of thought on the latter point. As a preliminary to this discussion, however, it is first necessary to define the term *inflation* as it will be used in this discussion. By inflation is here meant that condition in which prices are, for non-commodity reasons, raised to a level which is regarded as abnormal or excessive. I expressly set aside for the moment factors proceeding from the commodity side of the price ratio. Current advance in prices may be due either to influence exerted by the policy of banking and currency which has been pursued or by the methods of public finance which have been adopted or by other factors proceeding from the money side of the price equation or by all together. Thus used, the term *inflation* itself will not necessarily commit its user to any theory as to the exact means or the proportion of different means by which the condition has been brought about. It is a descriptive word and as such has no necessary implications of theory. By most of those who discuss the subject certain fundamental assumptions are made with reference to the connection between inflation and policies of banking, currency and finance, and this has often led to the diversion of discussion into dialectic paths and the development of a kind of *odium theologicum* which is anything but enlightening. There is no objection to this kind of discussion of the causes of inflation, except that it does not bring us to any definite point.

It is preferable to give the discussion a constructive turn since we are now at a critical stage in national development and our effort should be that of restoring permanently tolerable conditions. We have the coming generation for debating wiredrawn economic theories, but we have only the present moment for setting right existing conditions.

Looking at the question from this point of view and subject to these limitations, it seems to me that the subject assigned me this morning should be dealt with under three heads: (1) the question whether inflation is a good thing and as such to be continued; (2) the question how far the Federal Reserve system is affected by inflation; (3) the question what the Federal Reserve system can and must do in order to get away from inflation, if such a course be found to be desirable.

I.

Is inflation desirable?

The bald question whether or not inflation is desirable will usually be answered in the negative when it is put in the abstract, and yet at the present time there is a large school of persons who discriminate between the abstract and the concrete in this connection. They are first of all those business men and speculative interests who have found themselves able to profit through a steady rise of prices and who desire to see a further advance of prices in order that they may continue to make earnings in the same way as has been possible for them in the past. We need pay little attention to this group of apologists, since they are manifestly guided by self-interest. A second group of those who advocate the maintenance or continuance of inflation consists of those who believe that a retrograde movement, implying as it would a reduction of prices, would mean suffering and injustice as great as that which resulted from inflation in the first place, and who think it is not desirable to have the events of the past few years reenacted in the reverse order. They therefore urge that the present price level be recognized as permanent and that something be done to "stabilize" it or fix it at approximately its present point. This is the contention of Professor Fisher, who says in his book, *Stabilization of the Dollar*, that stabilization had better be undertaken at or near the present price level, although he contends that his plan would be compatible with a desire to effect a gradual reduction in prices. Bankers in many cases believe that reductions in prices will result in so wide a condition of stringency or inability to liquidate as to cause financial failure and collapse, and while fully admitting the injustice of the present situation they are

in many cases definitely inclined to think that less harm will be done by maintaining present levels, or at all events by making the retrograde movement extraordinarily slow. While much more might be said to amplify and enlarge upon the position taken by those who thus present a scientific and practical argument in favor of inflation, I believe that I have fairly stated their case, and let me add that their argument strongly appeals to me as containing a considerable amount of force. I am, however, definitely of the opinion that the weight of argument is on the other side and that it will be impossible to develop any satisfactory or effective scheme of economic recovery that does not provide positively for a gradual reduction of inflation. There is no difference of opinion regarding the injustice which has been produced by the inflationary process, and I believe there is little variation of view as to the location of the injustice.

It has fallen upon the rank and file of the people and has affected with greatest severity the small business man, the small investor, the person of fixed income, and in general the less highly organized and less defensive classes in the community. It is probably true that if the present level of prices could be stabilized we should eventually level up our wages, prices and other economic shares to the new basis of distribution. A study of the situation, however, shows that this levelling-up process is far from being completed and that those who advocate inflation fail to recognize that inflation, instead of having already borne its perfect fruit, has only made a comparatively small start in changing the old order which, in the world of fact as well as in poetry, only slowly "changeth giving place to new." We are, in short, not at a completed stage of our journey toward higher prices and the readjustment of shares in the distribution of wealth, but only at a half-way house from which we may go forward or backward, and in either case must incur much suffering, the one thing that is certain being that we cannot stand still. It seems to me, therefore, that the harm and evil of the retrograde movement will at least not be greater than that of the further forward movement. Apart from all this, however, is the fact that a determination not to restore the old level of prices, or at all events a lower one than that which now exists, has some very

serious implications which are usually overlooked. Foremost among these is the abandonment of the gold standard. I believe that those are right who contend that in order to return to a sufficient basis upon the present level of prices it will be necessary either to produce gold in enormously greater quantity by subsidizing its producers, or else to adopt some new departure like that of a stabilized dollar, in which gold itself becomes merely an incident in a currency system and not its tangible basis. We may question, however, rather seriously whether a plan for a stabilized dollar similar to that of Professor Fisher would succeed unless it had a larger backing of gold than could be afforded by the existing volume of gold in the world. A second implication which grows out of the determination to maintain the existing inflated scale of prices seems to me to be the continued maintenance of great differences between countries in the matter of banking liquidity and solvency. Were we convinced that we must maintain or peg our present system of prices, we could not view with equanimity the losses of gold which we are now suffering, no matter how seriously such gold might be needed by other countries. It would be a long time probably before all trading countries could be brought to anything like the same general degree of uniformity and similarity of banking and redemption conditions which existed before the war. To sum up, therefore, it seems to me that a maintenance of inflation means continued injustice, greater suffering than at present, failure to redress a very serious moral wrong inflicted upon the rank and file of the community, and the almost inevitable development of chaotic conditions of banking and currency, or in lieu thereof, resort to others that we know not of. The conclusion, therefore, must be that inflation is not a good thing and that effort must be made to return to a normal level of prices. This at once raises the question what is a normal level, a problem to which different persons will return different solutions, and which we need not definitely answer at this time since we are discussing merely the general question in which direction we shall turn our steps and not how far we shall go. It is not necessary to cross the inflationary bridge before we come to it, whether we go forward or backward, but merely to decide toward which bridge we shall direct our course.

II.

The second question suggested for discussion now presents itself—where does the Federal Reserve system stand with respect to inflation today? Bearing in mind the definitions already accepted as the basis for what is here said, this question becomes an inquiry how far the Federal Reserve system has diverged from its normal or standard condition. The Federal Reserve system was originally planned and organized as a system for the accommodation of business and for the discounting of paper of fixed maturity growing out of industrial, commercial and agricultural operations. At the present moment it is carrying in its portfolios about $1,500,000,000 of so-called war paper, and about $1,500,000,000 (discounted and bought) of unquestionably business paper. As a result of the topsy-turvy conditions created during the war, it is, however, reasonably to be believed that a percentage of the so-called war paper has in fact been given for business purposes and should therefore be regarded as abnormal in nothing except form. If, for example, A is a borrower at a bank who stands possessed of $500,000 of Government bonds and finds that he can borrow more cheaply at Federal Reserve banks by offering straight single-name paper collateraled by such bonds than he can by discounting the paper growing out of his operations, he will under ordinary circumstances prefer to borrow by offering the single-name note collateraled by Government bonds. Despite the changes in rates of discount that have been made from time to time in the Federal Reserve system, it still remains true that a differential exists in favor of war paper, and this prevents us from knowing exactly what proportion of the actual holdings of the Federal Reserve system consists of paper whose purpose is of such a nature that by the original or peace-time terms of the Act it would never have made its appearance in the bank portfolios at all. It is, however, a factor which must be reckoned with. It would thus seem that in order to get rid of inflation in the sense herein assigned to that term, that is to say, in order to return to peace-time prices, it will be necessary either to substitute somewhat less than $1,500,000,000 or possibly some $1,000,000,000 to $1,250,000,000 of paper growing out of commerce, industry and agriculture, in the Reserve banks, or else to see a reduc-

tion of corresponding amount in the portfolios of the banks. Needless to say, if the Reserve banks were to rediscount such a volume of actual commercial paper as to take the place of the total amount of actual war paper they now hold, there would be as great a volume of credit extant as there is today, and the question may be raised whether in that event there would have been any elimination of inflation. This question is, however, comparatively easily answered when it is remembered that such an accretion in the total amount of paper in the community, and hence in the Reserve banks, would be the result of a corresponding increase in the total volume of business, whereas our discussion is based upon the assumption that there is no change in the commodity side of the situation, but that that remains practically stable. The conclusion of this analysis, therefore, is that a return to normal conditions at the present time on the part of the Federal Reserve banks might involve a reduction in their portfolios of probably $1,000,000,000 to $1,250,000,000. Moreover, we must frankly admit that in so far as the Federal Reserve banks continue to retain this volume of paper in their portfolios, they would be contributing to the maintenance of inflation and would be aiding to sustain the existing level of prices. They would be, in other words, accepting the view that inflation is a good thing or that at all events it cannot now be corrected, nor should we try to correct it. It must not, however, be supposed that the control of inflation is entirely vested in the hands of Reserve banks or that the inflated paper of the country is all in their hands or under their control. The topic assigned me for discussion is the Relation of the Federal Reserve *System* to Inflation, and the system includes both the member as well as the Federal Reserve banks themselves. If we examine the conditions in member banks of the Federal Reserve system we shall find that, taking returns from banks in 100 selected cities as representative, and apart from Treasury certificates of indebtedness, there is in the aggregate a holding of loans secured by war obligations amounting to about $1,200,000,000, while, in addition thereto, there is a holding of loans secured by stocks and bonds other than United States Government securities of about $3,200,000,000, all other loans and investments being about $11,000,000,000. We may sum this up by saying that

the entire loans and investments of these member banks are about $17,000,000,000, out of which about $4,400,000,000 represent loans on non-liquid security, including both Government bonds and other obligations, and the stocks and bonds of private concerns. The figures thus given include bills payable with the Federal Reserve banks secured by United States obligations amounting to something like $800,000,000, but even deducting this sum there is left $3,600,000,000 or probably $2,000,000,000 more than before the war. To figure the total of such holdings in all banks we must assume a certain relationship on the part of the reporting to the non-reporting banks. If this be taken at 40% the excess of collateral paper over pre-war holdings might be $5,000,000,000. This means that member banks are carrying a very large volume of non-liquid obligations with which Federal Reserve banks have nothing directly to do. It is true that the members are in part able to continue this policy because of the discounts they secure from Federal Reserve banks, but it is also true that even if Federal Reserve banks should exclude from their own portfolios everything except eligible paper of the strictest kind, they would still have no means of preventing member banks from using the funds obtained by rediscounting for any purposes that they chose, and that if they chose to employ these funds in sustaining speculative operations they could do so. It may be answered that a higher rate of discount charged by Federal Reserve banks would compel many of these banks to discontinue their speculative loans because of the fact that they could not afford, or would not find it as profitable, to go on making such loans if they had to pay on the commercial paper which they rediscounted a rate of interest so high as to exhaust the profit they would otherwise make. The trouble with this view is that, as will presently be explained more fully, the rate of interest does not operate in the way thus indicated. In the case of many banks a moderate advance in rates of interest has no particular effect upon the volume of their rediscounts. Their rate to their customers is so much higher than any rate that is likely to be charged by a Federal Reserve bank that they are not especially affected in their applications for new loans by the circumstance of an advance in discount rates. A heavy advance in rates, uniform as it would necessarily be, would

cut off much desirable paper in financial and manufacturing centers, but it would leave the door open for much paper originating in out-of-the-way sections of the country where interest rates are phenomenally high. We have in the United States a problem of banking control which is different from any that exists abroad, and which offers a much more difficult application of the theory of control of the volume of credit by discount rates. Summarizing this situation, therefore, we must admit, I think, that whatever may be the responsibility of the Federal Reserve system for inflation, it has not today anything like full control of inflation, and that successful deflation can be effected only by the direct and active coöperation of member banks. This means the establishment of a general consensus of opinion in favor of deflation. It is not a result which can be accomplished by merely resolving to raise rates at Federal Reserve banks or by making it difficult or impossible for members to get credit. Careful selection of eligible paper, careful rationing of member bank borrowers, and the adoption of other means, will no doubt after a time produce results, but all these processes will necessarily be slow. How to apply them and how far and how fast to go, is the actual problem of the immediate present.

Here is the point around which banking discussion and criticism should properly center, not around what was done two or three years ago. Constructive work can be done by showing in what particulars the present policy of Federal Reserve banks errs or in what it is not adapted to the ends which are accepted as correct or sound by those who are expressing themselves. Believing, as I have said, that inflation is bad and injurious and that a return should be made as speedily as possible to a normal basis, using that term in the sense already defined, I am therefore led to the conclusion that Federal Reserve banks and their members should reduce their portfolios in an amount corresponding to the excess of non-liquid holdings over pre-war portfolios. This conclusion would not be of much value without the corresponding expression of opinion as to how long such a process should take. On that point any view that may be stated would be more or less empirical and ought not to be put forward with any claims to special positiveness. It seems to me that while the question is not one

which can be dealt with in an absolutely rigid way, we should endeavor to eliminate from Federal Reserve banks and their members' portfolios the war paper which they now hold and their excessive secured loans, at a rate to be determined upon the basis of careful studies of the surplus saving power of the community at the present time. It should be possible to figure a reasonable proportion or theoretic ratio in which current savings should be devoted to the retirement of public debt of the Government, to the absorption by investors of existing Government obligations now in the banks, and to other purposes. If after due study we should reach the conclusion that a sum of say $500,000,000 could be theoretically spared each year to the reduction of war paper and secured loans now in the hands of Federal Reserve banks and their members, I believe that each group of institutions should shape its course in such a way as to effect the due proportions of curtailment in its notes and deposits, and that it should adjust its policy and its rates of discount in such a manner as to accomplish that object. If it be answered that this is a purely theoretic and dogmatic way of treating the situation and that it takes no regard of business exigencies or current needs, that it endeavors to adjust our banking policy to a situation in which unforeseen requirements may present themselves and far-reaching changes may develop, the answer should be made that when such conditions open upon the world at large, it will be time to change the policy and that, as was said by an American financier, the way to resume is to resume. We shall never reduce the volume of our bank credit and currency, and we shall never approximate to a lower scale of prices until we definitely reach a determination upon the subject. We may leave the present situation to chance and allow the inflation to continue until a violent breakdown occurs, and then we may accept the resulting price level with the same philosophy that is adopted by some of those who defend existing conditions; but we shall do more wisely if we resolve upon a given policy, let it be definitely known throughout the country, and proceed with its application. That it will cause difficulty and embarrassment in some quarters it would be futile to deny. That it will prevent greater difficulty and greater embarrassment seems to me an inevitable conclusion.

III.

By what means can such a reduction of credit as has thus been indicated be effected, and what would be its results?

It is proper to deal with the latter part of the question first and to say that the results to be accomplished by it will depend entirely upon the degree of coöperation that can be obtained through the community. If there be investors who are willing to absorb or digest the war paper, the effects of the change should be greatly minimized. If, on the other hand, the process of pushing the war paper out of the Reserve banks finds but few investors who are willing to coöperate, the inevitable consequence would seem to be that of lowering the value of Government securities upon the bond market to a point where they will compete actively with other securities and thus will compel the investment of such fluid funds as there may be. In any event, the absorption of these securities by the public necessarily means the withdrawal of an equal amount of current funds from investment in other directions. It does not destroy capital, as some seem to suppose, but it withdraws it—that is to say, makes it unavailable for the purchase of new securities.

Furthermore, as we have already seen in connection with the second part of our problem, the elimination of inflation involves action on the part of member banks which would be parallel with that of Federal Reserve banks. Members must not only carry out the policy of Federal Reserve banks to the extent that they are compelled to do so as a result of the shrinkage of credit produced by Federal Reserve banks, but they must also go farther and apply the same point of view in the conduct of their own business. How far can they succeed in accomplishing any such result? This depends very much upon the coöperation they can obtain from the public. Suggestion has already been offered that advances in discount rates will not alone attain the desired results. It may also be added that for reasons which have already been stated, mere restriction of the kind and character of paper which is admitted to the system will in the same way fail to produce the desired results. Rationing the amount of credit among the different banks, either in the way indicated by the Phelan act or by less stereotyped and uniform methods, will from time to time produce an effect. But in the last analysis the elimination of inactive,

non-liquid paper from the banks can be effected only through the general growth of a public opinion which recognizes the harm and danger involved in continuing along present lines. As methods of leadership, advances in discount rates, plans for the application of the Phelan Act in the several districts, and efforts to ration, have their influence. In practice it is not desirable to destroy business or cripple industry in order to carry out a theoretical plan of reform. Steady refusal to admit any speculative paper to member banks, and steady opposition on the part of Reserve banks to the granting of extensive rediscounts to any members which are notoriously speculative, must be the principal methods to be employed in this connection. The suggestion of some conspicuous figures in the banking world that the reserve requirements of Federal Reserve banks be lifted and that the embargo on gold be restored cannot be described in any other than the strongest terms as a disastrous proposal, a concession to the worst spirit of wild inflation.

Perhaps all this may be best, even though vaguely, summed up in the statement that the proper policy to be pursued in reducing credit is found in the application of the principles of sound banking and in the return to those standards of banking which prevailed before the war. It is not possible to stereotype sound judgment or to lay down absolutely hard-and-fast regulations governing its exercise. The main thing, as already stated, is to establish a definite standard of contraction or reduction, and so far as humanly possible to bring about a shrinkage of credit to that extent. There are some indications that such a shrinkage is already under way. Exportations of gold taken from our excessive stock have done some good, and the attempt of some of the more farsighted members of the banking community to get out of the investment market and keep out of it have likewise been beneficial. The refusal to finance foreign trade by means of bank credit has likewise had a good effect, although not as good as would have been produced had the indirect financing of this kind been as steadily refused as direct financing. Perseverance in all these directions, and above all, the recognition of the distinction between investment and commercial banking will eventually restore our credit situation to a sound and normal position. Progress toward

such a condition will be more or less retarded or advanced by the progress of the rest of the world and we can hardly hope to attain a fully satisfactory situation until at least some decided progress has been made by other nations. The responsibility of the Federal Reserve system is that of holding fast to its ideas and guiding the banking community through a period of difficulty and inconvenience.